Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Chu	Analyst:	Anne Mazur	Bill Number:	AB 2344
Related Bills:	See Legislative History	Telephone:	845-5404	Amended Date:	April 6, 2006
		Attorney:	Patrick Kusiak	Sponsor:	State Controller

SUBJECT:	Voluntary Compliance Initiative 2/Underground Economy and Tax Gap

SUMMARY

This bill would require the Franchise Tax Board to develop and administer a second voluntary compliance initiative (VCI 2) for taxpayers that participated in abusive tax shelters.

This bill would also require the Employment Development Department (EDD) to develop and administer an amnesty for payroll tax liabilities. The EDD provisions will not be addressed in this analysis.

This is the department's first analysis of this bill.

SUMMARY OF AMENDMENTS

The April 6, 2006, amendments deleted intent language to establish a limited payroll tax amnesty for employers and inserted provisions establishing an abusive tax shelter voluntary compliance initiative to be administered by FTB, and a payroll tax amnesty to be administered by EDD.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to provide disincentives to tax shelter promoters and to encourage taxpayers that failed to participate in previous tax shelter initiatives to report and pay the correct amount of tax.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative on January 1, 2007. The bill specifies that the VCI 2 would be conducted from February 1, 2007, to May 15, 2007, for taxable years beginning before January 1, 2006.

POSITION

Pending.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP	S. Stanislaus	4/21/06
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ANALYSIS

FEDERAL/STATE LAW

Current State Law

AB 1601 (Stats. 2003, Ch. 654) and SB 614 (Stats. 2003, Ch. 656) were the first comprehensive anti-abusive tax shelter legislation enacted in this country. The two Acts created a voluntary compliance initiative (VCI 1) and increased reporting requirements and penalties. VCI 1 was a narrow opportunity for any taxpayer that used an abusive tax shelter to file an amended return to report and pay the correct amount of tax and applicable interest. The major provisions of the two Acts did the following:

1. Created a penalty for failure to disclose reportable transactions.
2. Modified an accuracy-related penalty for listed transactions and reportable transactions having a significant tax avoidance purpose.
3. Created a penalty for understatements from transactions lacking economic substance.
4. Modified the substantial understatement penalty.
5. Modified the tax shelter exception to confidentiality privileges relating to taxpayer communications.
6. Modified the registration of tax shelter requirements and the penalty for failure to register.
7. Modified the penalty for failure to maintain investor lists.
8. Created legal actions to enjoin the selling of tax shelters.
9. Modified the penalty imposed against a tax preparer for understating a taxpayer's tax liability.
10. Modified the penalty on frivolous tax returns and submissions.
11. Modified the penalty for promoting tax shelters.
12. Extended the statute of limitations on assessments for tax shelter transactions.
13. Expanded the Franchise Tax Board’s authority to issue subpoenas.
14. Modified the provision on suspension of the accrual of interest.
15. Increased the interest rate on underpayments of tax.
16. Created an interest-based penalty for reportable transactions.

The existing penalties enhanced by the legislation, listed above, were waived for taxpayers that participated in VCI 1.

VCI 1 also required persons selling abusive tax shelters—promoters—to disclose information about their sales activities in exchange for a waiver of monetary penalties that would otherwise apply to them.

VCI 1 ran from January 1, 2004, to April 15, 2004. Approximately 1,200 taxpayers participated in VCI 1, which resulted in the state collecting an additional $1.4 billion in tax revenue in 2004.

Current Federal Law

Federal law regarding abusive tax shelters essentially conformed to California's laws with the enactment of the federal American Jobs Creation Act (AJCA) of 2004. There are several substantive and numerous subtle differences between federal and state laws.

To avoid confusion over small differences between federal and state law, AB 115 (Stats. 2005, Ch. 691) changed California's anti-tax shelter provisions to more closely match federal law. Some substantive differences remain between federal and state law, including the disclosure requirements applicable to promoters and the threshold amount for the penalty for failure to disclose a reportable transaction.

Generally, federal law provides for a 20% accuracy related penalty (ARP) as the consequence for participating in an abusive tax shelter transaction. The federal settlement initiative discussed below automatically reduces the ARP to either 5% or 10%, depending on how egregious the shelter transaction. The IRS may also reduce the ARP further if the taxpayer relied on an independently written legal opinion letter that concluded that the underlying transaction had greater than a 50% chance of being upheld as the proper tax treatment.

In September, 2005, the U.S. Department of Justice, in conjunction with the IRS, entered into an agreement for deferral of criminal proceedings against KPMG, a large accounting firm suspected of promoting abusive tax shelters. The agreement requires KPMG to cooperate fully with the IRS investigations into identifying tax returns that utilized abusive tax shelters. In exchange for cooperating with the IRS, KPMG will not be criminally prosecuted, but certain monetary penalties will still apply. Criminal proceedings are still pending against certain former partners and employees of KPMG.

On October 27, 2005, the IRS announced an administrative abusive tax shelter settlement initiative. This settlement initiative was open to most taxpayers that had a federal income tax benefit from any of the 21 specifically-identified abusive tax shelter transactions. Taxpayers under criminal investigation or in litigation with the IRS on an abusive tax shelter were excluded from the settlement initiative. Promoters were also excluded.

All taxpayers wishing to participate in the federal settlement initiative must have elected to do so by January 23, 2006. Participants must also make full payment of tax, interest, and any applicable penalties when the signed closing agreement is returned to the IRS or be approved for an installment payment plan. FTB announced a similar, conforming initiative for those taxpayers that elected to participate in the federal settlement initiative. Pursuant to the California Tax Shelter Resolution Initiative[1] (the California Initiative), FTB will refrain from pursuing the more stringent California tax shelter penalties created for VCI 1 (most significantly, the non-economic substance penalty (NEST)). In exchange, the taxpayer is required to provide FTB all documentation underlying their tax shelter transaction.

[1] FTB Notice 2006-01; elections due March 31, 2006.

THIS BILL

This bill, if enacted, would be referred to as the "Underground Economy and Tax Gap Act of 2006." The bill would declare that California "needs to aggressively pursue measures to uncover the underground economy and curtail unethical and illegal tax evasion schemes."

The bill would establish VCI 2 to run from February 1, 2007, through May 15, 2007, for the purpose of motivating taxpayers to file an amended return and pay the correct amount of tax. The bill would also strengthen existing penalty provisions for taxpayers that used abusive tax shelters, in addition to strengthening penalties on the tax shelter promoters and the tax professionals that provided material advice to taxpayers. The material provisions of the proposed VCI 2 are summarized below:

1. A taxpayer that could have participated in the above-described IRS settlement initiative would be prohibited from participating in VCI 2. Thus, a taxpayer involved in a shelter that was not one of the 21 transactions specified by the IRS may participate in VCI 2. Additionally, a taxpayer that is subject to a criminal investigation or that has a criminal complaint filed against him or her would be ineligible to participate in VCI 2.
2. VCI 2 would be offered to taxpayers beginning February 1, 2007, and ending May 15, 2007, for taxable years beginning before January 1, 2006.
3. The taxpayer would be required to file an amended return reporting all income and loss without regard to the abusive tax shelter transaction and pay the tax and interest. The taxpayer would be allowed to request to pay the tax and interest under an installment agreement.
4. The taxpayer would have an elective option under VCI 2:
    - Option A – Voluntary compliance without appeal rights. This option would include waiver of all penalties. The taxpayer's understatement of tax would be subject to a 50% increased interest rate. The statute would provide that if the taxpayer's amended return is accepted by FTB, the issue would be considered closed.
    - Option B – Voluntary compliance with appeal rights. This option would allow waiver of all penalties, except the accuracy related penalty (ARP). The taxpayer's understatement of tax would be subject to an increased interest rate of 50%. The statute would provide that if the taxpayer's amended return is accepted by FTB, the taxpayer may file a claim for refund for the tax and interest paid under VCI 2 after a specified time and the occurrence of certain events. If the taxpayer's claim prevails, a refund with interest would be issued. If the transaction is determined to be abusive, the taxpayer would be liable for the ARP.
5. The ARP would be modified so that the taxpayer would lose the benefit of the "reasonable cause" exception to the ARP if the taxpayer fails to do any of the following:
    - Participate in VCI 2,
    - Provide basic tax shelter documentation, or
    - Notify FTB of any federal increases to the taxpayer's tax liability.

6. Raise the penalty amount for aiding and abetting to $25,000 and $100,000, for individual taxpayers and corporate taxpayers, respectively, from the current $1,000 and $10,000 amounts. The standard for imposing the aiding and abetting penalty would be changed to "should have known" that their actions would lead to an understatement of tax. The current standard is that the aider or abettor knew or had a "reason to believe" their actions would lead to an understatement of tax. This change would place greater responsibility on the tax professional to assure that the correct amount of tax is reported and paid.

7. This bill would increase the normal interest rate charged on underpayments of tax (currently 6%) by half for participants in VCI 2. Increased interest rates would also apply for nonparticipants:
   - For amended returns filed after the end of VCI 2 and before contact by FTB, double the normal interest rate would apply to tax shelter underpayments reported on such returns.
   - For any other tax shelter underpayment determined after the end of VCI 2, two and one half times the normal interest rate would apply.

8. FTB would be required to notify other agencies, such as the State Bar of California, the Board of Accountancy, and the federal Securities and Exchange Commission that a tax shelter penalty was imposed.

IMPLEMENTATION CONSIDERATIONS

The impact of the provisions of this bill on the department's programs and operations would require some changes to operations and processes.

LEGISLATIVE HISTORY

AB 115 (Klehs, Stats. 2005, Ch. 691) changed California's anti-tax shelter provisions to more closely match federal law.

AB 1601 (Frommer, Stats. 2003, Ch. 654) and SB 614 (Cedillo, Stats. 2003, Ch. 656) required FTB to develop and administer a voluntary compliance initiative and enhanced existing and established new penalties and reporting requirements relating to tax shelters.

PROGRAM BACKGROUND

Although there is no precise legal definition of an abusive tax shelter, an abusive tax shelter generally involves a transaction or a series of transactions that on the surface appear to meet the letter of the tax law; however, the underlying transactions lack economic substance and consequently are a sham. The economic substance doctrine (ESD) is a judicially created doctrine and today is elementary to examining the validity of a tax scheme. The ESD states that a transaction, after being stripped of its tax benefits, must have more than a de minimus amount of economic value for the parties to the transaction. This does not mean that tax benefits must be absent from the value of the transaction; however, tax benefits cannot be the principal reason for entering into a transaction.

Most abusive shelters use numerous but purportedly separate transactions to arrive at the desired tax result. Taxpayers create pass-through entities and spread the sham transactions over multiple tax years to complicate the ultimate purpose of the transactions and to impede identification by auditors. Today's shelters are sophisticated to the extent that a highly trained tax professional is required to discover the abusive shelter. A flowchart diagramming a basic abusive tax shelter is attached as Appendix I.

FISCAL IMPACT

Staff estimates the cost to implement the provisions of this bill, including developing and administering VCI 2, to be approximately $500,000.

ECONOMIC IMPACT

FTB has previously estimated the tax gap from abusive tax shelters to be $3.3 billion in California during the years covered by this bill. It is estimated that $2.3 billion of this total will be collected by FTB by January 1, 2007. These collections come from several sources including: payments made under the first VCI in 2004, payments made during the 2005 general tax amnesty (including "protective claims"), collections from FTB audit activity, and payments to the state under the California Initiative. The rate at which taxpayers will choose to participate in VCI 2 is highly speculative. Given the information that is currently available, it is possible that VCI 2 could bring in between $100 million and $500 million of the $1 billion remaining to be collected.

ARGUMENTS/POLICY CONCERNS

Self-compliance through a VCI 2 is warranted because:

- It would provide a means to address the $1 billion of tax that remains unreported and unpaid due to abusive tax shelters.
- It would be an effective and efficient means of collection rather than awaiting potentially lengthy audits.
- It would leverage for California the information to be obtained because of recent agreements between the IRS and KPMG.
- It would create an incentive for taxpayers that participated in abusive tax shelter transactions that are not included as one of the 21 specified transactions for the federal settlement initiative to report and pay the correct amount of tax.
- It would allow taxpayers that were poorly advised by their tax professionals to disregard the 2004 initiative to heed the advice of these same tax professionals who would now advise taxpayers to participate in VCI 2.

VCI 2 would curb future promotion of abusive tax shelters both by amending the aiding and abetting penalty so that tax professionals must abide by a higher standard, and by requiring FTB to notify other government agencies when tax shelter penalties are imposed.

LEGISLATIVE STAFF CONTACT

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Assembly Bill 2344 (Chu)
Amended April 6, 2006
Appendix 1

Inflated Partnership Basis Shelter

Using a stockbroker, TP obligates himself to sell ten $1,000 T-Bills worth $10,000 today on the open market to be delivered in 14 days. Buyer pays broker $10,000, which broker deposits in TP's account with an unknown liability equal to the value of the ten T-bills in 14 days.

TP contributes the $10,000 and contingent liability to a partnership. TP's basis in the partnership is $10,000.

TP liquidates the partnership after holding the partnership interest for the full 14 days and closes the short transaction.

If on day 14, the FMV of ten $1,000 T Bills is only $9800, the TP will recognize a $200 gain. All but $200 of the $10,000 was used to purchase the ten T Bills. The FMV of the partnership is now $200. TP's basis in the partnership interest is $10,200 ($10,000 original + $200 gain). Upon liquidation the TP will recognize a $10,000 loss ($200 cash received - $10,200 basis).

$10,000
Short Sale of
10 T-bills

Economic Reality Leg

Close short sale by purchasing 10 T-bills for $9,800 leaving $200 of gain

Taxpayer has $200 gain

Tax Shelter Leg

Contribute $10,000 cash + contingent liability to partnership

Close short sale by purchasing 10 T-bills for $9,800 leaving $200 of gain

TP Liquidates ptsp & distributes $200 gain

Basis of TP's ptsp interest:
$10,000 + $200 gain = $10,200

Taxpayer Net Loss From Partnership Liquidation

Gain ………………………	$ 200
Less: Basis of ptsp interest …	$10,200
Net Loss …………………...	$10,000